

Hungary: Leveraging political influence

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Hungarian–Russian relations have changed considerably during the last decade. Until the mid-2000s, it had been a limited and cautious relationship with many reservations on both sides. Hungary had a high FDI/GDP ratio with heavy reliance on EU markets, thus curtailing the Russian share in foreign trade and investments. The political landscape had the traditional for CEE societies left-right divide regarding relations with Moscow, based on the dichotomy of “pragmatist” leftist parties and skeptical conservatives. The return to the Eastern markets (“Eastern opening”) was the focus of the former, while political and security threats were accentuated in the latter’s discourses. Energy dependence remained a sensitive issue, with sporadic Russian hostile takeover attempts in the sector repulsed by the governments with bi-partisan political support.

In 2017, Hungary’s Russia policy assumed a significantly different profile. By far the biggest factor in this policy turn has been the ruling majority giving up their objections against closer ties with Russia. Viktor Orbán, the leader of this majority, and a former staunch critic of Russia for two decades, has refashioned himself into one of Moscow’s most vocal defenders in the midst of its war in eastern Ukraine. While in opposition, Mr. Orbán criticized the government in 2008 on the grounds that he would not want to see Hungary become the “happiest barrack of Gazprom,”² but concluded a huge nuclear deal with Rosatom, Russia’s state nuclear energy corporation, while in government in 2014. Mr. Orbán’s party, Fidesz, has become the party supported by the most pro-Russian voters in the Hungarian political landscape.³ The right-wing radical Jobbik, Hungary’s second-strongest political formation according to opinion polls, has denounced what it sees as Fidesz’s pro-European stance and favors even deeper engagement with Moscow – a historically unprecedented orientation in Hungary’s nationalist political segment.

The unexpected shift toward pro-Russian foreign policy requires a deeper investigation. Russian influence has many variations throughout the CEE region. In Poland, the Law and Justice party, albeit being anti-liberal, adopted an even more hostile stance toward Russia. At first sight, Hungary seems to be a showcase of interaction between the deterioration of democratic standards and growing Russian influence. However, unlike in Bulgaria or Serbia, Moscow does not have a strong economic or institutional foothold in Hungary. With the exception of Jobbik, Russia neither had major grassroots projects of influence, nor visible ownership in the local economy. Its presence in terms of gas and oil imports has been declining fast since 2008 and bilateral foreign trade has suffered a serious drop after 2014 and the imposition of EU sanctions against Russia. Russian influence shows little signs of having a bottom-up design with traditional state capture by Russia’s local business partners and influential middlemen, deeply entrenched in local elites. The government and the country is

¹ Csaba Weiner’s work was supported by the János Bolyai Research Scholarship of the Hungarian Academy of Sciences.

² Magyarország jobban teljesít. 2007. “We Don’t Want to Become Gazprom’s Happiest Barrack,” January 9.

³ Index.hu. 2017. “A Fideszesek a Legnagyobb Oroszbarátok,” April 13.

firmly in Viktor Orbán's grip and there is little chance to bypass him or create a *fait accompli* in any major issues.

In reality, Russia's influence in Hungary primarily rests on elite relations. Moscow approached directly the top decision makers and strengthened its influence only in a number of selected, albeit strategic, fields. In these areas, it succeeded in putting its leverage on a long-term footing and preventing the realization of other policy outcomes. Energy was the showcase of this process. The South Stream gas pipeline project led to a major policy rivalry with the Nabucco pipeline after 2007. Gazprom's price concessions formed a key platform for a utility rate cut pledge, which aided Orbán's electoral campaign in 2013 and cemented his re-election in 2014. The deal to construct new units at Hungary's Paks Nuclear Power Plant (Paks II), signed in January 2014, determines the nuclear energy sector and partially even the financial landscape in the country for the next decade.

Against this background, this chapter will demonstrate how Russian energy statecraft worked in the case of Hungary. Russia used sectoral asymmetries in bilateral energy relations to achieve non-sectoral outcomes. The Kremlin employed the energy question as an agenda-setting issue with specific benchmarks of negotiation. At the same time, Moscow also used energy to engage and create asymmetrical commitments vis-à-vis Hungary, transferring its energy influence to other policy fields.

The Russian economic footprint in Hungary

As in many other CEE states, Russia used to be the biggest non-EU trading partner for Hungary prior to 2014. Nonetheless, exports to Russia constituted only 1.3% of the Hungarian GDP in 2016 (peaking at 2.6% in 2010). In terms of commodity structure, the difference from West European patterns is small. Manufactured goods, machinery, and transport equipment provide the bulk of the volume, most of it in the form of re-exports of products by foreign multinationals operating in Hungary. Agricultural products, foods, and beverages contributed a relatively low share – 12.1% of the total in 2016. This is also a strong indication of the limited role sanctions and counter-sanctions politics have played in influencing export performance. The Russian crisis after 2014 hit the bilateral export levels hard – they fell by 43% between 2013 and 2016 (in euro terms). Nevertheless, the overall effect on Hungarian exports was much smaller as goods were presumably easily redirected to other markets. Consequently, total Hungarian exports actually grew by more than 10% in the same period.

Hungary's imports from Russia, on the other hand, consist almost exclusively of mineral fuels, predominantly oil and gas. According to official statistics, their share was only 1.7% of GDP in 2016. Given the high number of intermediaries and indirect imports, their actual share must have been closer to the total oil and gas imports – 3.6% of GDP (7.9% in 2013). Internal energy demand in Hungary decreased gradually after 2009, especially in the case of natural gas, contributing to the fall in import volumes. Bilateral trade balance has been traditionally passive, but with a diminishing trajectory. The deficit peaked in 2008 amounting to 3.9% of GDP, while in 2016 it reached only 0.8% (even when oil and gas imports officially registered as non-Russian are added, the indicator remains well below 2%). The negative trade balance has lost much of its significance because since 2010 total Hungarian foreign trade has been in a solid surplus position, well above 5% of GDP. This is in contrast to the period prior to the 2008–2009 financial crisis when the country had to cope with major financial imbalances, including a negative foreign trade balance.

Statistics on Russian FDI in Hungary show only a few major transactions, particularly the unsuccessful takeover attempt of the Hungarian oil and gas company Mol Nyrt by Surgutneftegaz, Russia's third-largest oil producer, and several deals connected to the

Rahimkulov family. Except for these deals significantly affecting Russian FDI flow and/or stock data, in statistical terms Russian presence has remained low both from the point of view of Russia as well as of Hungary.

Mostly because of *de jure* or *de facto* tax havens and offshore centers intermediating Russian FDI, official FDI statistics on the basis of the immediate host/investing country provided by the central banks of Hungary and Russia deliver different perspectives of the 2010s. For the end of 2015, the Russian central bank shows that Russian FDI stock totaled USD 230 million,⁴ compared to Hungarian central bank's EUR 46.4 million. For 2009 and 2010, two outlier years due to Surgutneftegaz's takeover attempt of Mol, Russia's share still accounted for only 1.6% and 2.2%, respectively, of Hungary's total inward FDI stock. Measured as a share of GDP, Russia reached a share of 1.2% and 1.5%, although one of the highest FDI flows that Hungary received in 2009 came from Russia.⁵ According to the Russian calculations, at the end of 2009 and 2010 Hungary's share in total Russian outward FDI stock did not exceed 0.8%. At the end of 2016, it was only 0.06%, putting Hungary in 11th place among 16 CEE countries.⁶

In Hungary, there is no publicly available accurate data on the total number of companies with Russian capital. Citing unnamed Russian sources – but essentially just reiterating information that had already been circulated by its predecessor ITD Hungary – both the Hungarian Investment and Trade Agency and the Russian trade representation claimed that over 2,000 joint ventures with Russian ownership were operating in Hungary. In contrast, according to Eurostat methodology, there were only 166 Russian-controlled enterprises in Hungary in 2014, while 3,534 Russian-controlled enterprises operated in the EU, compared to 265,000 foreign-controlled enterprises.⁷ These data do not include all the companies with Russian involvement. The share of Russian-controlled enterprises in the number of foreign-controlled enterprises in Hungary was only 0.91% in 2014, making an almost invisible 0.03% contribution in terms of the total number of enterprises in Hungary. The shares of Russian affiliates in the total turnover and the number of persons employed of all foreign affiliates in Hungary in 2014 were of similarly low proportions, amounting to 0.51% and 0.12%, respectively.⁸ A detailed survey of corporate registry statistics shows that the revenues controlled by Russian companies had shrunk from the peak of 4.9% of the total revenues in the economy in 2008 down to 0.07% in 2015.

Apart from Russia's presence in the energy sector, there are only a limited number of other important, Russian-owned assets. In Hungary, there have only been two Russian-owned banks, including, in the past, the General Banking and Trust (ÁÉB), and now Sberbank Hungary, a subsidiary of the Russian state-owned Sberbank. Sberbank Hungary targets Russian private and corporate clients' trade between the CEE and CIS countries.⁹ Press reports suggest that Moscow leaders were not altogether satisfied with the prevailing state of affairs at the bank and the media regularly float a potential exit from Hungary. The 8.5% stake (with a voting power of 8.6%) of the Rahimkulov family in Hungary's leading retail bank, OTP Bank Nyrt, considered a portfolio investment and estimated at 0.5% of Hungary's GDP, is also worth mentioning, as it constitutes by far the biggest item on the list of Russian investments in Hungary. OTP Bank is the largest Hungarian domestic bank, the main holding of Hungary's most influential businessman, Sándor Csányi. His interests stretch from Mol to the agricultural industry, multiplying the importance

⁴ Central Bank of Russia. 2017. "Russian Federation: Outward Foreign Direct Investment Positions by Geographical Allocation in 2009–2017."

⁵ Magyar Nemzeti Bank. 2017. "Direct Investment Flows in Hungary, Excluding SPE's."

⁶ Central Bank of Russia. 2017. "Russian Federation: Outward Foreign Direct Investment Positions by Geographical Allocation in 2009–2017."

⁷ Eurostat. 2017. "Foreign Control of Enterprises by Controlling Countries (from 2008 Onwards)."

⁸ Hungarian Central Statistical Office (KSH). n.d. "Activity of Foreign Affiliates (FATS)."

⁹ Sberbank Hungary. n.d. "No Title."

of the Russian market for his empire (not mentioning OTP's investments in Russia). Nonetheless, Sándor Csányi's control over OTP is undisputable.

Besides energy and banking, a large Russian (and also Ukrainian) industrial investment in Hungary is the ISD Dunafer steel plant. At the end of 2003, Dunafer was tendered and bought by a consortium, consisting of Ukraine's Industrial Union of Donbass (ISD) and the Swiss Duferco International Trading Holding Ltd. Severstal also submitted a bid. However, a change of ownership occurred in late 2009, when Russian investors obtained a stake of 50% plus two shares in the metallurgical assets of ISD. After that, as a creditor, Russia's state-owned Vnesheconombank practically controlled ISD. The European steel industry and, in particular, Dunafer have been struggling since the 2008–2009 crisis. In 2013, a cost optimization program was announced. Reacting to this news, the Hungarian government offered to buy ISD Dunafer, but the proposal was declined. Consequently, the fate of the company has become a sensitive political issue.

Vnesheconombank is a prevalent mediator and investor in Hungarian-Russian relations. It bought a significant share in the national airline Malév. After the latter's bankruptcy in 2011, it unsuccessfully sued to get back its EUR 112 million credit from the Hungarian government. Reportedly, it keeps trying to litigate a bilateral arrangement with Budapest.

In the Hungarian machine-building industry, in light of Paks II, the most relevant company with Russian involvement is Ganz Engineering and Energetics Machinery, owned by TsKBM, a part of Rosatom's machine-building division Atomenergomash. The activities of Uraltrak are also related to the machine industry – it is the only official Hungarian dealer of Russia's Chelyabinsk Tractor Plant – Uraltrak, owned by the Russian state-owned Uralvagonzavod.

Another relatively wide-known Russia-owned company is LIT Budapest that deals with disinfection technologies, including the use of UV in the purification of drinking water, wastewater, technological water, and water for swimming pools and spas. Russia's LIT is reportedly among the world's top three developers and manufacturers of UV systems for water, air, and surface disinfection.

The reasons for the low Russian FDI activity are manifold. Hungary had a relatively swift economic transformation and an extensive privatization process, including in some major segments of the energy sector in the 1990s. Key positions in the national economy had already been occupied by private companies by the late 1990s when – with a couple of exceptions¹⁰ – the first Russian actors capable of investing abroad consolidated themselves. By the late 1990s, Hungary had almost fully privatized its economy. In the energy sector, the emergence of a domestic private company, Mol, played a crucial role in pushing back Russian investment efforts. In turn, Prime Minister Orbán's recent drive for renationalization partly explains his limited openness to new Russian FDI. The Hungarian government has recently bought back a high number of energy assets from Western investors, and it would like to keep these for the long term. Furthermore, the Russian capacity for new investments has been diminished by the 2008–2009 financial crisis and, more recently, by low oil prices and Western sanctions against Russia. Consequently, FDI may now even constitute a less accentuated part of Russian influence in Hungary than prior to 2008.

Effects of Russia's economic footprint on Hungarian governance and decision-making

Unlike in other former communist countries in Europe and the former Soviet Union, deliberate Russian influence-building started relatively late in Hungary and in the rest of the Visegrád Group. Consequently, Moscow had to enter an established local economic and political

¹⁰ RUSAL and Economist Intelligence Unit. 2006. "The Russians Are Coming: Understanding Emerging Multinationals," p. 17.

landscape, where the transition process had already ended and new systemic actors and relationships were in place. Due to the late consolidation of the Russian economy in the early 2000s, its oligarchs failed to penetrate Visegrád markets. Russia's economic resources were insufficient to compete with the high shares of Western FDI and the solid economic performance of these nations. At the same time, Moscow also enjoyed some benefits of its late arrival. First, the very limited presence saved its image in terms of nation-building. While in Ukraine, Moldova, and Georgia, the fight against Russian influence was a rallying factor in some political discourses, in Hungary it was the Western influence and multinationals that took the "enemy of the nation" role in radical public narratives. Second, Russian influence has been built in a more strategic-political context from the very beginning. Ownership, trade, or economic considerations formed a much more instrumental role and Russia's actions had a broader set of targets.

In this light, it would be misleading to assess Russian influence only through the traditional variables of measurement. The relational portfolio consists of various elements, where indicators of FDI or shares in foreign trade alone do not reveal the nature and the magnitude of the Russian footprint. An illustrative case is the Russian 10-billion-euro credit line for the Paks II project. While it cannot be incorporated in any of the above-mentioned sets of indicators, its sheer size is roughly three times bigger than the highest estimates for total Russian-related investments in Hungary. If Hungary fully utilizes this credit line, it will create a direct government-to-government channel on a liability equal to 10% of Hungarian GDP. Similarly, the status of the long-term gas supply contract (LTSC) as well as its form, duration, and other conditions may signal highly different policy relations and outcomes. Thus, a broader look at these non-conventional indicators of economic presence is warranted.

Russian economic influence is not a wholesale phenomenon. The fundamentals of the Hungarian economy have not changed during the term of Mr. Orbán's government – they rest on a massive presence of Western multinationals and deep integration into European value chains. Russian capital in the region was not a match to these Western affiliates. Nevertheless, Russian capabilities and Mr. Orbán cabinet's receptiveness intersected in the energy sector. The government's wish to renationalize and control the utilities and trader activities, to get access to their financial flows and to use energy prices in a populist manner for electoral purposes was a major window of opportunity for Moscow. Thus, the internal transformation of the energy sector interwove with the increasing Russian presence. Moscow could effectively engage the Mr. Orbán government through this branch and not only maintain, but even significantly increase the set of deep, long-lasting and interlocking positions. Energy was one of the drivers of bilateral rapprochement. Yet, Moscow did not aim to acquire ownership of or direct control in the Hungarian sector by all means unlike in the case of Bulgaria, Serbia, and Latvia. This was neither possible due to local renationalization trends, nor necessary. It tried to consolidate its energy leverage in times of a changing energy landscape through major arrangements and potentially transfer its influence beyond the sector. This can be characterized as a sort of energy statecraft, whereby Russia aims to establish a self-supporting presence in Hungarian energy and extend it to other fields. Russia's newborn energy statecraft in Hungary has four main features.

First, the relationship in the energy sector is based on a growing number of large-scale and long-term arrangements bearing high corruption and management risks.¹¹ Some of these risks

¹¹ Susan Rose-Ackerman. 1999. *Corruption and Government: Causes, Consequences, and Reform*. Cambridge: Cambridge University Press.

Marcel Hertogh et al. 2008. *Managing Large Infrastructure Projects: Research on Best Practices and Lessons Learnt in Large Infrastructure Projects in Europe*. The Netherlands: AT Osborne BV.

McKinsey. 2013. "A Risk-Management Approach to a Successful Infrastructure Project. Initiation, Financing, and Execution," *McKinsey Working Papers on Risk* 52.

are general: energy usually comprises oligopolistic market designs;¹² delivered products are sometimes very complex (like nuclear);¹³ in some cases these relations are bilateral monopolies, reducing the applicability of market-based solutions and resulting in distributive games;¹⁴ and informational asymmetry in these cases favors the supplier's side.¹⁵ Nonetheless, the Hungarian side entered these arrangements – such as South Stream, the gas LTSC or Paks II – voluntarily.

Second, the Hungarian energy landscape went through a major renationalization campaign, changing the bargaining power and the nature of negotiations substantially. The former role of foreign multinationals has been taken by state-owned enterprises (SOEs). In the gas industry, in 2013, state-owned MVM (Hungarian Electricity Works) purchased the gas wholesaler from Germany's E.ON, holding the LTSC.¹⁶ South Stream Hungary, a former joint venture to build the Hungarian section of South Stream, had been permanently held by various state-owned entities since its founding in 2008, bypassing the privately owned gas transmission operator (TSO), FGSZ. The Paks II project has been directly controlled by the Prime Minister's Office, taking it entirely out of the corporate environment. Indeed, state ownership in the energy sector can be beneficial in particular cases. It may improve the international bargaining position, ease the process of capital and resource allocation, and utilize synergies at complex projects with industrial policy overflows or with a sensitive technology content.¹⁷ At the same time, considerations related to social welfare take a more sizeable role in the activities of SOEs,¹⁸ managerial decisions are often vulnerable in politicized environments, and economic efficiency and political power relations have to be taken into account simultaneously.¹⁹ This may frequently offer inroads for political patronage and rent-seeking behavior, while principal-agent corruption schemes can be set up much more easily. Furthermore, in the Hungarian case, the renationalization of the gas sector increased the informational asymmetry with Russia, since there had been no gas companies and sectoral know-how in state ownership until 2010. Given Fidesz's concept of "political governance," the nationalization process also implied a more direct subordination of technocratic and economic considerations to political concerns.

Third, the Russian-related segments have taken the dominant role in energy investments, handicapping alternative energy market outcomes. This is primarily the result of the Paks II project swallowing up almost all accessible public funds in the generation of energy in the years

¹² Alberto Ades, and Roberto Di Tella. 1995. "Competition and Corruption," *Draft Paper*, Oxford University.

¹³ Flavio Menezes. 2000. "The Microeconomics of Corruption: The Classical Approach," *EPGE – Ensaio Econômicos* 2000/11.

¹⁴ Carol Dahl. 2015. *International Energy Markets: Understanding Pricing, Policies, and Profits*. Tulsa, Oklahoma: Penwell Corporation.

¹⁵ David Easley, and Maureen O'Hara. 1998. "Contracts and Asymmetric Information in the Theory of the Firm," *Journal of Economic Behavior & Organization* 9, no. 3: 229–246.

¹⁶ Hungary has two LTSCs, both of them with Gazprom Export, Gazprom's export arm. The major one is with MVM's Hungarian Gas Trade (formerly Mol Natural Gas Supply and then E.ON Natural Gas Trade), Hungary's leading gas trader through Panrusgáz which is the Russian–Hungarian gas intermediary joint venture and Gazprom's main ownership interest in Hungary. This contract was signed by Mol. Concluded in 2007 for the period 2008–2028, a tiny contract has been entered into with Centrex Hungary, an affiliate of the Gazprombank-owned and Vienna-based Centrex Europe Energy & Gas AG. When talking about the Hungarian LTSC, the authors refer to the major one.

¹⁷ Raymond Vernon. 1979. "The International Aspects of State-Owned Enterprises," *Journal of International Business Studies* 10, no. 3: 7–15.

¹⁸ Yair Aharoni. 2000. "The Performance of State-Owned Enterprises," in *The Rise and Fall of State-Owned Enterprise in the Western World*, edited by Pierangelo Maria Toninelli. Cambridge: Cambridge University Press, pp. 49–73.

Dieter Börs. 1981. *Economic Theory of Public Enterprise*. Berlin: Springer-Verlag.

¹⁹ Spiros Lioukas, Dimitris Buorantas, and Vassilis Papadakis. 1993. "Managerial Autonomy of State-Owned Enterprises: Determining Factors," *Organization Science* 4, no. 4: 645–666.

David Stark, and Balázs Vedres. 2012. "Political Holes in the Economy: The Business Network of Partisan Firms in Hungary," *American Sociological Review* 77, no. 5: 700–722.

to come. Public funds play an even more important role in the sector due to the shrinking activities of private investors and companies. Populist measures and the regulatory squeeze have minimized utility tariffs, leading energy companies into the red. Investments in the electricity and gas sectors have crumbled, falling from 1.06% to 0.17% of GDP between 2010 and 2016.²⁰ Coupled with the extensive and highly selective regulatory practices, practically no investments can be made on a private basis and almost all activities are concentrated in the SOEs.

Fourth, the government's thinking rests on the conviction that the current *quid pro quo* basis of the bilateral relations is beneficial for Hungary. This belief is rooted in the government's foreign policy concept that sets economic and business considerations as the primary focus for diplomacy. In 2014, Prime Minister Orbán announced his goal to increase the share of non-EU countries to one-third in total exports by 2018. Political, security, and "Western civilizational" aspects are downsized in the new mindset.²¹ Furthermore, the government's anti-liberal, harsh Eurosceptic rhetoric has been perceived as a potential bargaining chip *vis-à-vis* Moscow. Russia is taken as a "strong buyer" of these criticisms, an actor who is ready to monetize and provide economic benefits in exchange of political friendship and non-conformity with the EU and NATO. Thus, it is reasonable to think that the Hungarian government would like to increase its Russian portfolio and open new dossiers if advantages are discerned.

These characteristics of the Kremlin's energy statecraft in Hungary are markedly present in three, possibly interrelated issues dominating the Hungarian energy landscape since 2012.

South Stream

Hungary pursued an intensive dialogue with Russia on South Stream from its public appearance in 2006 until its suspension in 2014. Excluding a short interruption between 2009 and 2012, Budapest remained deeply involved in the project and supported its realization. The construction was first promoted by the left-liberal Gyurcsány government, ruling the country until 2009. The-then opposition party Fidesz criticized South Stream forcefully, but changed its mind after its 2010 landslide electoral victory. By mid-2012, when Nabucco–West failed to win the race against the Trans-Adriatic Pipeline, the Greece–Albania–Italy pipeline, Fidesz could publicly turn to South Stream as the only viable option for supply from the south.

The national sections of South Stream had very similar patterns in each transit country. The main policy arguments in favor were better access to Russian gas, increased supply security by reducing transit risks, and strengthening the countries' bargaining position in LTSC negotiations. At the same time, the project brought a regulatory clash with the European Commission: Gazprom refused to launch the usual regulatory approval procedure, while its contractual regimes with the transit countries, even the intergovernmental agreements, comprised several controversial points. This was most visible in the Bulgarian case, resulting in the suspension of the project. Gazprom was also relatively safe from project preparation risks: the unilateral cancellation of the project did not result in financial compensation for the transit states.

Nonetheless, South Stream played the role of a catalyst of bilateral relations. Being a flagship project, its political preparations attracted the attention of local political elites and established a permanent system of high-level meetings and contacts. Unlike Bulgaria and Serbia, in Hungary Russia did not have a local web of middlemen capable of organizing a broad bilateral agenda. Especially in the case of Fidesz in 2012, relations had to be constructed from scratch, due to Viktor Orbán's formerly anti-Russian attitude. Furthermore, Gazprom had no other platform to officially meet senior Hungarian decision makers. Since the whole gas value chain was privatized in Hungary by domestic and foreign companies, the government did not have a

²⁰ Eurostat. 2018. "Gross Capital Formation by Industry (up to NACE A*64)."

²¹ Magyarország Kormánya. 2014. "Józan Ésszel És Bátorsággal Kell Képviselni Az Országot," August 25.

full mandate to discuss gas-related matters. Formally, Gazprom and the government could not pursue negotiations on gas import prices without the inclusion of the E.ON management. Another factor enhancing exclusive talks was the separation of South Stream from the gas transmission operator into a state-owned entity in order to bypass the privately owned Mol. Not surprisingly, Prime Minister Viktor Orbán started a major nationalization campaign and raised MVM as a state-owned sectoral national energy champion, creating its “gas leg” right after his landslide electoral victory. There was a clear wish on the part of the Hungarian side to engage Russia in a broader set of gas issues, but it lacked the mandate and credibility until the end of Mr. Orbán’s first term. South Stream negotiations to some extent substituted this institutional deficit and accelerated the process of sectoral re-politicization.

Even in the midst of this difficult start, Mr. Orbán’s government remained loyal to the project until the last moment. Its commitment to the project even led to a change in the national legislation, passed in early November 2014, circumventing EU law.²² The legal change allowed any company that is not necessarily certified as a gas transmission operator to build a gas pipeline, making Gazprom eligible for the construction of the South Stream project on Hungarian territory. The latter mirrors a Bulgarian parliament decision from April 2014 to adopt at first reading amendments in the country’s energy law, granting South Stream a special status as an interconnector project, thus avoiding the EU’s Third Energy Package. The whole issue became obsolete after the suspension of the construction by Russia.

Since then, the issue of pipeline-building has remained a semi-official topic in Hungarian – Russian relations. It pops up regularly in different forms like the Tesla pipeline in 2015 or a murky interconnectivity project, where Bulgaria and Serbia are supposed to be already partners of Gazprom. What is common to these initiatives is that the Russian side keeps them extremely low profile, hardly anything is known about them, and there has not been any meaningful activity afterwards. Thus, these discussions lack a reasonable degree of credibility. Obviously, these pipelines still have a considerable role in bilateral negotiations, but it would be difficult to decide whether these are empty rhetorical undertakings or signal a more tangible commitment.

Conveniently timed gas contract concessions

The domestic policy shift from energy security considerations toward social affordability was to some extent imminent in most of the CEE countries, which revealed their higher vulnerability to Russian influence. Due to high oil and gas prices, combined with relatively low GDP per capita, the share of utility costs in citizens’ overall expenses in the Visegrád countries was almost twice higher than the respective share in Western Europe.²³ For many low income households the payment of gas and electricity bills has been an everyday challenge. These social affordability considerations have thus contributed to a politically driven regulatory squeeze on the profitability of the utility sectors and partial renationalization at the corporate level. Not surprisingly, the rising gas import prices and their upward pressure on utility tariffs became a major issue on the political agenda in the early 2000s.

It was the conservative Fidesz campaigning with the slogan of “cheaper gas,” while social-liberal coalition governments tried to balance between economic reality and social considerations. Utility rate reduction became Fidesz’s electoral silver bullet, practically representing the single most prominent slogan by the end of the campaign. Presumably, it was the utility rate cut that boosted Fidesz’s popularity, which swelled from a low point of 1.3

²² Georgi Gotev. 2014. “Hungary Attempts to Bypass EU Law on South Stream,” *Euractiv.com*, November 4.

²³ The share of total utility and fuels spending in total household expenditure in Hungary was 7.5% and 5% in 2010 and 2016, respectively. The similar shares in EU15 were 4.1% and 3.8%. Eurostat. 2018. “Final Consumption Expenditure of Households by Consumption Purpose (COICOP 3 Digit).”

million supporters in 2012 to 2.1 million by the time of the elections, granting Viktor Orbán a new constitutional majority.

Simultaneously, as mentioned previously, the government succeeded in buying out E.ON from the wholesaler, holding the LTSC with Gazprom in October 2013. Through the purchase, the cabinet entered into a direct negotiation contact with Moscow. Fidesz had to face the controversy ensuring after the nationalization, whereby increased losses in the gas value chain had to be covered by state-owned corporations. Given the roughly EUR 1.7 billion annual turnover on the Hungarian gas market by that time, the utility rate cut would have created a sizeable deficit in the new owner's (MVM) balances. In this situation, in 2013 Gazprom agreed to provide some beneficial modifications, granting Hungary a significant price concession. Close to the finalization of the Paks II credit line agreement, Gazprom committed itself to another set of concessions in February 2014, lowering the mandatory take-or-pay levels.²⁴ This help became vital in managing the gas value chain amid the sharp utility rate reduction campaign.

These concessions were not unprecedented in Western Europe but were rather uncommon in the CEE region. During 2012, many West European utilities renegotiated their LTSCs and brought them into line with market realities at the time. Nevertheless, in the CEE region, in the first half of 2012 prices varied between EUR 30 and 43 per MWh and in most of the cases their level exceeded Gazprom's German export price by 15–40%.²⁵ The take-or-pay concessions were of even bigger significance. As shown earlier, the Hungarian gas consumption virtually collapsed, falling from 13 to 8 bcm in less than a decade. Thus, Gazprom's temporary flexibility and gradual release at these clauses brought a good deal of relief to the Hungarian side.

All of these concessions came at a time when they had a high political relevance for Fidesz in the midst of its electoral campaign. The modifications also took place simultaneously with the Paks II negotiations, starting at the signing of the intergovernmental agreement²⁶ in January 2014, and followed by the agreement on the Russian credit line in March 2014.²⁷ It would be difficult to state that Gazprom's decision was completely unjustified, but its timing and relatively early action in a CEE comparative context suggest a good deal of preferential treatment. It is reasonable to assume that gas pricing concessions were not fully independent from these issues.

The Paks project: a game changer

The potential exchange of political favors between Hungary and Russia in commercial gas contracts, is dwarfed by the other major energy deal of this period – the Paks II project. In 2012, the Paks power plant generated 45.9% of the gross electrical power produced in Hungary, rising to 52.2% in 2015.²⁸ These blocs were to be decommissioned after the expected end of their life cycle in the 2030s. Given their huge share in the electricity mix, the substitution of this capacity was of major importance for the country. Hungary does not have significant coal deposits, while the most plausible substitutes, natural gas and renewables, were considered to be expensive and unreliable. Thus, there was a strong support for nuclear energy among the industrial and governmental circles, and that renouncing it completely was considered an utterly heretical

²⁴ Reportedly Gazprom offered a price discount above 10% in October 2013 and further, major takeover concessions in February 2014. Argus FSU Report. 2014. "Gazprom Eyes New Hungary Deal," June.

²⁵ Regional Centre for Energy Policy Research (REKK). 2013. "Földgáz Nagykereskedelmi Modellalternatívák 2015 Után Magyarországon," p. 14.

²⁶ "Law No. II/2014," 2014.

²⁷ "Law No. XXIV/2014," 2014.

²⁸ Hungarian Energy and Public Utility Regulatory Authority (MEKH). 2012. "A Magyar Villamosenergia-Rendszer (VER) 2012. Évi Statisztikai Adatai."

Hungarian Energy and Public Utility Regulatory Authority (MEKH). 2018. "Annual Data on Gross Electricity Production, 2014–2016."

idea. Energy policy discussions have been long dominated by the “Paks only” argument. Policy debates about the necessity, timing, and the scale of these new blocs have been ruled out from the very beginning. The incoming Orbán government also signaled its wish to maintain nuclear capacity in the country in its 2011 National Energy Strategy.²⁹

Still, the deal between the Hungarian and Russian governments announced in January 2014 was a major surprise for many. It had been prepared in total secrecy, without any public or political debates, lacking administrative and industrial justification. The agreement envisages the construction by Rosatom of two new reactors to be commissioned in the mid-2020s with a total capacity of 2,400 MW, worth EUR 12.5 billion. The overall value of the project exceeds 12% of the current Hungarian GDP and raises many concerns related to the future opportunities entailed for Russian influence.

The exact motivation for the sudden decision to implement a major nuclear construction project remains unclear. Given that the early launch of the new units is expected to be in 2025–2027, six nuclear blocs will produce electricity simultaneously until 2032 (when the lifetime of the first existing Paks bloc constructed in 1982 expires). This is an opaque decision, causing further physical and financial uncertainties and complicating the feasibility of the new units. There was no time pressure to decide about the substitution of the old blocs and the nuclear option could have been left open until the early 2020s. Regulatory issues have been fully ignored especially as far as conformity to EU standards was concerned. The European Commission had launched several investigations regarding public procurement (the lack of tendering), potential state aid aspects, and transparency considerations (the past and future decisions related to the project were classified). Most of these pitfalls of the project have been successfully averted (at least by 2017), but at the time of the signature there was no certainty about the actual outcomes.

The financial aspects also create a considerable set of problems. There have been no economic analyses of potential alternative options and the government failed to deliver evidence that the project would be profitable. Russia had been pushing for this project for at least five years. It offered a 40% localization rate, which in absolute terms would equal approximately 5 billion euros. It is highly questionable whether the Hungarian industry will be capable of delivering the requested quality in such a high proportion. Furthermore, the construction may boost the regional economy and provide some spillover effects of limited scale. Nevertheless, it is unlikely that only these sweeteners were sufficient to persuade the government for such a risky project.

On the other hand, the financial burden is sizable. If the budget were to bear the entire cost of the project, it would have increased the deficit/debt as a share of GDP by 1.3% per year over the construction period. While this, or a combination of other financing solutions, does not seem to be impossible to bear for Hungary, it is obvious that there would be significant pressure to make budgetary adjustments, especially if the government is ruling out a steep increase in the power tariffs paid by households. Even so, the European Commission has already signaled that the project may cause tensions with the Commission’s Stability and Growth Pact and contribute to Hungary’s negative debt trajectory. The Russian credit line with its tiered interest rate of around 4–5% (in euro) gives only a partial relief in this regard, but increases the Russian bargaining power in the construction phase significantly.

Moreover, hardly anything is known about project management. The government commissioner responsible for Paks II has argued that the contracts oblige Rosatom to deliver turnkey blocs by the deadlines, thus the risks on the Hungarian side are minimized.³⁰ The three implementation agreements signed in December 2014 are fully classified with all the related past and future data for 30 years, according to a specific law passed by parliament. At the same

²⁹ Ministry of National Development. 2012. “National Energy Strategy 2030.”

³⁰ hvg.hu. 2014. “Paks II.: A Garancia Az, Hogy ‘mi Sem Vagyunk Kispályások’,” December 9.

time, the Finnish nuclear safety regulator postponed the issuance of a permission for the construction of the same type of blocs in Finland by one year due to severe shortcomings in management, including engineering attitudes to safety and coordination problems with the new technical design.³¹ Rosatom's Leningrad blocs had been planned to be laid by 2013 and 2016, respectively, but due to a variety of reasons, encompassing construction problems at the sites and capacity abundance on the market, the official deadline has been shifted to 2018 for the first unit.³² Because of similar reasons, the Baltic I project has been suspended, and the Novovoronezh II unit is expected to start commercial operation only after nine years of construction in 2019. Given the problems with Rosatom's own projects and the relatively weak Hungarian project management record, the complexity of the project in terms of permits and other legal aspects, the management and sharing of project risks between the parties are of vital importance.

The Fidesz government also resorted to extreme legislative measures to shield the Paks II project from public scrutiny. A bill adopted in March 2015 exempted the project from Hungary's Freedom of Information Act, classifying all information related to the design, construction and funding of the two nuclear reactors for 30 years. The law cited unspecified national security interests and the protection of intellectual property rights in general as grounds for the blanket restriction that left no discretion for data controllers and rendered the option of judicial review of any refusal to gain access meaningless.³³ The government was forced to partially retract these restrictions a year later after an EU Pilot procedure concluded that the amendment violated EU disclosure requirements.

The corruption risks have to be highlighted in this regard. As detailed in an assessment by corruption experts commissioned by Energiaklub,³⁴ a Budapest-based energy policy think tank, the risks common to all large infrastructure projects are in this instance compounded by shortcomings of the deal in question. International empirical studies on similar projects demonstrate that at least 5% of the value of such investments is exposed to corruption risks. Hungarian data suggest that the corresponding value may be as high as 13–16%, with higher priced investments being associated with higher corruption-related losses.³⁵ A significant degree of information asymmetry arises from the heavy reliance on the expertise of the contractor regarding the complex technologies of which only it has full knowledge. This can be exploited by the Russian party through overpricing and a number of other means. Overpricing is also an issue when considering the high number of subcontracts such an investment project generates.

Overall, the significance of the Paks II contract does not lie exclusively in its sheer size and long-term nature. At this stage, it is the single most solid element of the Russian presence that stretches Moscow's influence well beyond the tenure of the incumbent government. It makes Russian influence more irreversible when an exit is very costly and ambivalent from the policy point of view. It creates a necessity for any future government to conduct complex negotiations with Russia and rely on Russian goodwill. Thus, it is reasonable to define Paks II as the axis of Russian energy statecraft.

³¹ Marja Ylonen, et al. 2017. "Evaluation of the Safety Culture of the Hanhikivi-1 Project Key Organizations: Fennovoima, RAOS Project and Titan-2."

³² Mycle Schneider, and Antony Froggatt. 2016. "The World Nuclear Industry – Status Report 2016."

³³ Hungarian Civil Liberties Union (TASZ). 2015. "Hungary Classifies All Information Regarding Paks Nuclear Plant."

³⁴ Mihály Fazekas, Zsolt Főző, and István János Tóth. 2014. "Az Atomerőmű-Beruházások Korrupciós Kockázatai: Mire Számíthatunk Paks-II Esetében?" *Corruption Research Center Budapest*.

³⁵ Mihály Fazekas, Zsolt Főző, and István János Tóth. 2014. "Az Atomerőmű-Beruházások Korrupciós Kockázatai: Mire Számíthatunk Paks-II Esetében," *Corruption Research Center Budapest*, p. 3.

The overall question which remains is whether Russia's energy statecraft in Hungary has irreversible features or is it only a temporary phenomenon that may disappear when political conditions change.

First, it is important to note that the impetus for engagement came from both sides. It was not only Russia engaging Hungary, but also Budapest seeking access to Moscow. In this regard, the domestic image of Russia, Hungary's threat perceptions and calculations about political and business compatibility were of major importance. The ruling elites still have high expectations with respect to this nexus despite the fact that changing economic, political, and security trends all point to the contrary. Indeed, notwithstanding the almost negligible activity in terms of Russian public procurement during the collapse of Hungarian exports after 2014, which was one of the expected factors for a breakthrough, Budapest still believes that the Russian connection may contribute to the diversification of the Hungarian economy. Moscow was very successful in identifying these windows of opportunity, perhaps even nurturing these beliefs and creating a fertile soil for its influence.

Second, a successful transition from communism and smooth integration into Western value chains do not shield entirely against Russian leverage. Hungary still actively cooperates with Western multinationals, competes for their investments, sometimes successfully. Eastern contacts and relations with major investors come on the top of these achievements. The Russian economic nexus is not a substitute, but a supplement to the Western one. Unlike countries which focus on the service sector that turns out to be vulnerable in times of crisis, Hungary has a robust manufacturing sector in Western ownership. Nevertheless, these contacts proved to be insufficient for the Hungarian government and it wanted to create alternative networks and attract investment also from non-Western countries through political bargaining.

Third, energy is the field where Russia can permanently preserve its credibility. This is important if the decision to launch a cooperation with Moscow has been taken. Positive receptivity is available and the ideological objectives in the two capitals at least partially overlap. The potential fear of the Russian capacity to influence domestic politics is, however, also present. In such a situation, energy ties can deliver the evidence that bilateral relations work and flourish. A realistic balance of economic relations would point toward a major downsizing of engagement with Russia. Nevertheless, Hungary still pursues an open foreign policy toward Moscow and energy relations obviously play a crucial role in it.

Fourth, Western powers and institutions have little leverage to stop this process. Hungary has permanently provided the strategic minimum *vis-à-vis* the NATO and the EU and could even withdraw if the minimum is significantly exceeded. Consequently, its relations with Russia have remained in the pool of tolerated, even if not welcomed, policies. Budapest, under certain conditions, got the green light from the European Commission in all the sensitive issues related to the Paks II project; it could start a similar project with the Chinese in railway infrastructure. Bilateral talks have continued to be active despite the EU's silent consensus not to invite Putin to EU territory. In this regard, Western diplomatic isolation and political signals simply failed to constraint Hungarian-Russian engagement. Since the government sees these strategic boundaries lying rather far ahead from their current position, the story does not seem to be over yet.

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